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ABSTRACT

Designed for high school economics students as a public service project of the American Fletcher National Bank, the booklet examines America's decreasing productivity rate in terms of the efficiency. Natural resources, labor, skilled management, and capital are essential to the productive process. When there is an increase in the cost of the production process without commensurate improvement in productivity, inflation occurs. The resulting sluggishness can only be compensated for by higher prices, thus making American products less competitive in world markets. Economists suggest that the leading causes of decreasing productivity are: (1) rapid growth of service industries; (2) high taxes and low profits; (3) soaring energy costs; (4) high cost of regulation; (5) inadequate support of research; (6) a decline in personal savings; (7) wages rising faster than productivity; and (8) lack of managerial attention to the problem. One approach to increasing productivity is to recognize the importance of continuing education programs to improve skills and techniques for increased production. Accelerated educational-motivational programs for employees in addition to rewarding increased production with higher pay, promotions, and bonuses are also suggested. Also, less resistance to technological innovation is necessary to stimulate production. (LH)

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PRODUCTIVITY: AMERICAN'S CRITICAL NEED TO WORK SMARTER

FUNDAMENTALS OF FREE ENTERPRISE

No. 5 Revised

1982

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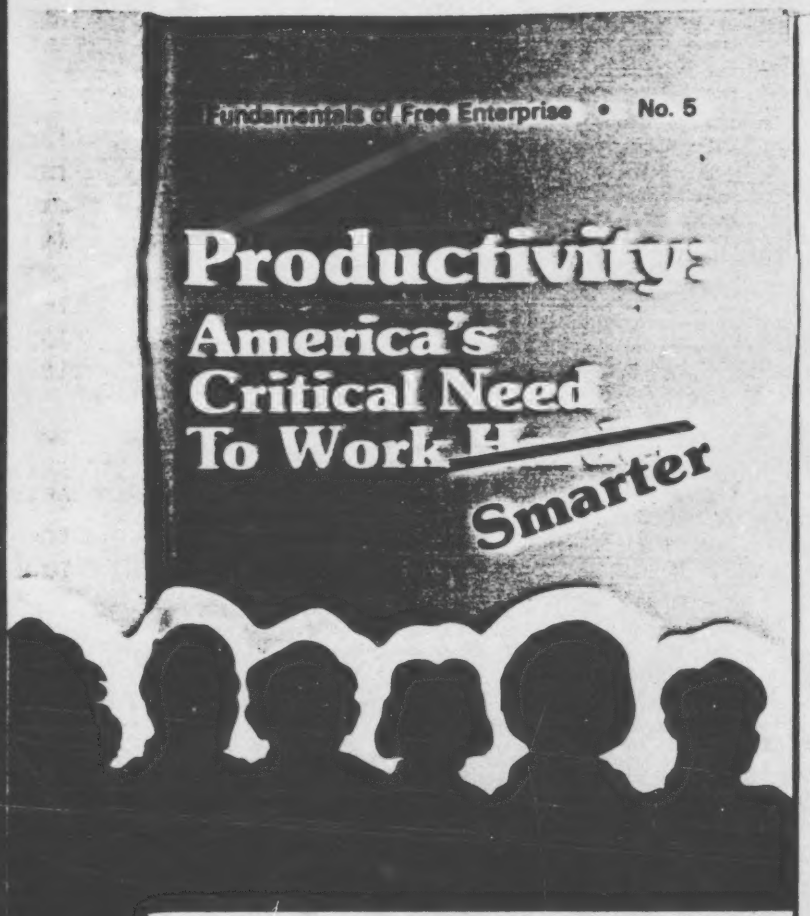

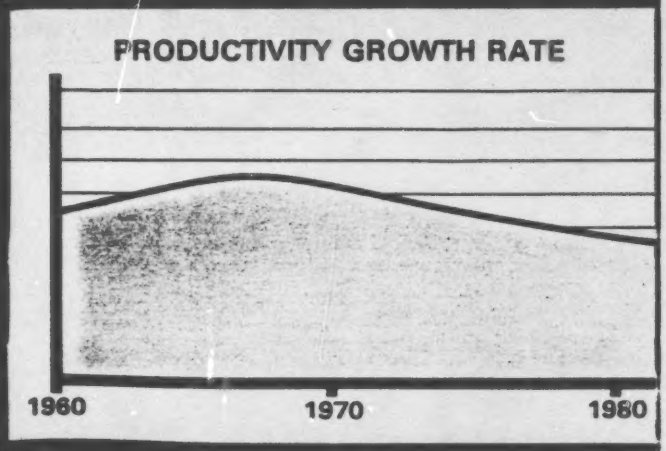

For a people who think of themselves as the hardest-working, most industrious on earth, it comes as a rude jolt to Americans to learn they are falling behind other countries in something so basic as *productivity*.

Nevertheless, that disturbing theme is appearing more frequently these days in scores of government reports, magazine articles, and newspaper columns.

Almost daily someone reminds us that a host of nations — Japan, West Germany, Italy, France, and Canada, to name only a few — has surpassed the United States in the ability to wring the most productivity from their resources.

This is deflating news to most Americans, who have traditionally believed in the innate superiority of our industrial might, in the virtues of our rigid work ethic, and in so-called "Yankee ingenuity." Now to hear that the Japanese, the West Germans, and the Canadians are outproducing us — impossible!

If by the word *productivity* we meant simply how *hard* we work, Americans could rightfully question the news about our declining position. The American worker who struggles home dead-tired every day after eight hours on the job would have

reason to be skeptical.

But lower productivity doesn't necessarily mean that Americans are slacking off or "goldbricking" on the job.

Nor does it mean that in sheer volume other nations are producing any *more* than we are. We still roll off assembly lines more automobiles, telephones, refrigerators, and virtually any other product you can name, than any nation on earth.

Productivity is simply a measure of the *efficiency* with which we turn out goods and services. It is a comparison of the *cost* of producing something versus the *volume* of the finished product. To use the language of economists, it is a measure of the *output* per unit of *input.*

For example, Farmer A and Farmer B may each spend $15,000 in labor, materials, and equipment to cultivate their respective 100-acre farms. But if Farmer A has a yield of 100 bushels of corn per acre and Farmer B's yield is only 88 bushels per acre, we say that Farmer A has greater productivity than his counterpart.

Thus, when we say other nations are passing us in productivity, it simply means they're producing more efficiently. It doesn't mean they're working harder; it could

mean they're working smarter!

Productivity is an issue that goes to the very heart of the American economic system. It is an important factor in our economic growth. Low productivity impedes wages and profits, slows the development of new products and services, stifles creation of new jobs, and delays increases in the standard of living.

A close examination of the fundamentals of the productive process will tell us why. Four ingredients are essential to that process:

Natural resources—all the raw materials from our environment which either can be refined into a marketable product or provide the energy needed to operate machinery and equipment.

Labor—the people who are physically involved in converting those raw materials into goods, either through the operation of tools and machinery or, less frequently these days, with their bare hands.

Skilled management—the people whose organizational skills are necessary to make the process operate efficiently.

Capital—the money necessary to invest in plants and equipment, to buy the

raw materials, and to pay labor and management for their contributions to the process.

How well all those forces are brought together in a common effort determines the relative productivity of the system, whether it's a total national economy or an individual company.

Increased productivity enables companies to pay higher wages to labor, to make profits to reward investors, and to expand the organization *without* raising the price of the finished product to the consumer.

To illustrate, let's examine the purely fictional Acme Shoe Company. If it costs Acme $55 — in labor, raw materials, capital investment, energy and management — to manufacture a pair of shoes, the company can sell its shoes at $59 a pair and make a reasonable "gross" profit.

This $4 in profit may be divided many ways — some of it as a reward to labor and management in higher wages or bonuses, some of it to pay dividends to stockholders for their investment, half of it to be paid to the government in taxes, and some of it to replace and buy additional equipment and facilities so more shoes can be manufactured next year.

The only way Acme can hold its price at $59 the following year — while at the same time paying higher wages and producing enough profit for dividends and business expansion — is to produce *more* shoes *without* an appreciable increase in cost of production.

If the *cost* of production increases to $57, for example, and there is no corresponding increase in *efficiency* of production, Acme will need to raise the price of its shoes to $61 merely to stay even.

In competitive markets, companies try to improve productivity so large price increases won't be necessary to sustain growth and profitability. If that is not accomplished, and a competitor discovers how to produce more economically without raising prices significantly, there is always the risk that the competitor will reap an even larger share of the market — and perhaps ultimately drive you out of the marketplace.

Productivity, therefore, measures how well a company, or an entire national economy, can generate goods and services more efficiently without relying on hefty price increases for stability and growth.

Anything which adds to the cost of the productive process

without a commensurate improvement in productivity will inevitably generate price increases — or a condition we call *inflation.*

The fact that the United States has experienced unprecedented inflation in recent years — to the degree that Americans now call it one of our major problems — is one good indicator that something is amiss in our rate of productivity. In short, we're not getting enough output for our input!

There is no clear consensus among economists on the best way to measure productivity, but one of the most-used tools is something called *output per man-hour.* It is simply an index of how many man-hours are necessary to produce a certain volume of goods and services. It is *not,* as the name implies, how *hard* employees work but how *efficiently* they produce.

For more than 20 years after World War II, output per man-hour in American industry increased by about 3.2 per cent a year — a figure that no other nation has been able to match over a prolonged period.

Output began to slip noticeably in the late 1960s, however, and has been going downhill ever since. For most of the 1970s, the annual growth rate in productivity averaged only 1.5

per cent, and by 1980 it had started to decline.

Such figures, of course, must be understood as *averages.* Some sectors of the American economy performed better — some more poorly.

Over the years, for example, the American farmer has been remarkably productive. From 1950 to 1970, agricultural production increased by two-thirds while farm employment dropped two-thirds. That makes for incredible productivity when measured by output per man-hour.

Conversely, there are other industries which have shown virtually no productivity gains; some have actually fallen behind. In 1979, for example, the Department of Labor noted that 21 of 67 major industrial groups showed outright losses in the hourly output of their workers.

Still other sectors of the economy, notably in the service field, probably cannot generate large productivity increases because they are so labor-intensive. As one social critic has observed, it still takes 30 minutes for the barber to cut one's hair, two hours for the lawyer to counsel his witness, and 15 minutes for the nurse's aide to bathe and serve the patient.

When all the parts are assembled, however, it results in

a story of productivity that is increasing at an ever-slower rate.

This sluggishness in productivity has come at a bad time for American companies. Faced with rising costs in most facets of production, industry has been forced to pass those expenses along to consumers in higher prices. This, in turn, has made American products less competitive in world markets, has helped weaken the value of the dollar in international trade, and has all but eliminated any real gains in purchasing power that workers could have derived from increased wages.

The obvious question, of course, is why our productivity growth has slowed so much. What has gone wrong with the way labor, raw materials, capital and management are being blended in our productive process?

There are dozens of theories, but most economists suggest the following as leading causes:

Rapid Growth of Service Industries—Over the last 30 years the number of jobs in service fields — those positions which produce no tangible product — has grown by 120 percent, while manufacturing employment has grown only 30 percent. The U.S. Department of Labor estimates that 86 percent of all job increases since 1970

have been in services, where productivity is difficult to measure and, as one critic describes it, often "produces nothing more tangible than piles of paperwork and airy advice."

Of special concern to some analysts is the fact that nearly 3 million of the 98 million employed in the country now work for the Federal government, which comprises the largest bloc of employees in the service field.

Other observers are equally vocal that a growing emphasis on services is no cause for alarm. Dr. John Kendrick of George Washington University says, for example, "We're accustomed to thinking only of jobs that produce goods as being productive. But anything that satisfies human wants is productive. The growth of services merely indicates that our wants have broadened. It doesn't mean we're less productive."

Others also insist that the productivity of service workers can be measured and the efficient ones are contributing significantly to the profitability of organizations for which they work.

High Taxes and Low Profits—Unquestionably, American business leaders are caught in a dilemma posed by large blocs of

people who apparently misunderstand the importance of profits in the country's economic system.

On the one hand, business is under great social pressure to create jobs for a growing work force and to invest in new plant and equipment to improve the productivity rate. At the same time, business is criticized for trying to make a level of profit that would help make those two goals attainable.

In March 1979, for example, there was an angry response by many Americans to a Department of Commerce report that after-tax business profits had risen by 15.8 per cent in 1978 in comparison with the previous year. Many considered the increase an indicator of excessive profits.

Overlooked in the story was the fact that profit margins for American business have been slim during most of the 1970s and that the 1978 figure offered only partial relief from a downward trend.

After inflation was factored out, the typical manufacturing company still earned only 5.4 cents on every dollar of sales in 1978, compared to 6.6 cents in the mid-1960s.

The slowdown in real profit is reflected dramatically in the case of General Motors Corporation.

In 1978, GM had $63.2 billion in gross sales, compared to $35.7 billion in 1973. But GM's '78 *net* income in constant dollars — with inflation factored out — was actually $8 million lower than its '73 net income. The company's profit margin eroded from 6.7 per cent in '73 to 5.5 per cent in '78.

Business leaders contend good profit margins must be sustained to attract the needed investment for new jobs and machinery.

The fact that government continues to dig ever-deeper into both corporate and personal earnings is a growing concern.

For example, in 1972 the cost of federal and state government alone — not counting local taxes — consumed about 27 percent of our Gross National Product. By 1977 the federal and state tax bite from the GNP had climbed to 31 percent, and there are few signs that the trend is slowing down.

Many fear that mounting taxes are destroying incentive for improved productivity for both businesses and employees. When increased earnings may lift you into a higher tax bracket, resulting in little increase in take-home pay, the desire to "get ahead" is dampened.

In addition, many are concerned that the tax burden is inhibiting the ability of business

to create new jobs. Social critic Martin Mayer says, for example, that about $40,000 will be needed to create *each* of the 2 million new jobs needed for workers entering the job market over the next decade. Faced with social pressure to make this investment to hold down unemployment, where will American business get the money to improve plant and equipment for increased productivity?

Soaring Energy Costs—Cheap energy, which at one time was a major factor in boosting productivity, is now a thing of the past. In many fields, for example, the cost of energy is rising much faster than labor, leading some managers to suggest facetiously that it would be cheaper to shut down their energy-consuming machines and return to the days of manual labor.

High Cost of Regulation—Business leaders have become increasingly vocal about the drain on productive capital caused by the high cost of complying with government's environmental and safety regulations.

One who has stated the case succinctly is Willard G. Butcher, president of Chase Manhattan Bank. He writes:

> "In 1977 alone, according to our research, government regulation cost us (the American people) more than $100 billion. In terms everyone can understand, $100 billion equals $470 for each person living in the U.S., and 5 per cent of the gross national product . . .
>
> "On the federal level alone, more than $3 billion covered the salaries and supplies of the army of 100,000 workers who staff the 41 regulatory agencies. . .
>
> "The largest part of the $100 billion regulatory budget — about $85 billion — was in compliance costs — the price businesses and individuals paid to respond to regulation. The private sector is forced to fill out more than 4,000 different federal forms each year, an activity that last year took upwards of 143 million man-hours at a cost — including legal fees, salaries, benefits, and overhead — of $25 billion."

Butcher goes on to suggest that if even half of the regulation bill had been invested in productive projects, it would have created about one million new jobs — an amount equal to the *total* work force of Indianapolis and Cincinnati combined.

Is this bad — the fact that we are paying this much to clean up the environment and show extra concern about worker safety? Not necessarily. But we must realize we are paying a high cost for it — a price that is helping us

lose ground to world competitors like West Germany and Japan.

Inadequate Support of Research—Experts disagree about how much of our Gross National Product should be reinvested in research and development (R & D) activities to improve our productive capacity and foster new products.

Some are alarmed by the fact that the number of patents issued to U.S. residents has declined steadily since 1971, citing that as proof that we're falling behind the rest of the world in technical innovations.

Others contend that American business is spending as much or more than it ever did for research and that we are producing a steady stream of new products.

There does appear to be unanimous concern about one issue, however, and that is the declining role of federal support for research activity. Ten years ago, federal funds supported more than two-thirds of all R & D in the country. In 1979, projections indicate the federal government will pay less than half of the cost of research, leaving private business to pick up an ever-larger share.

Whoever pays the bill, the importance of new technology to productivity cannot be overstated. A 1977 Department

of Commerce study says, for example, that from 1957 to 1973 high technology companies in the U.S. created jobs 8% percent faster than other businesses, while their productivity grew 38 percent faster.

A Decline in Personal Savings—Many analysts are concerned that Americans are spending more and saving less of their disposable income. This can spell trouble for companies seeking capital to invest in new equipment and products.

Personal saving in America dipped to 5 percent of disposable income in 1978, the lowest percentage since World War II and down considerably from the 8 percent level in the mid-1960s.

The U.S. rate of personal savings is the lowest of all major industrial nations in the world. In contrast, countries like Japan, France, and West Germany have never fallen under a 15 percent savings rate in the last five years. This means, of course, that companies in those nations always have a ready reservoir of capital investment to generate productivity increases.

Wages Rising Faster Than Productivity—Many economists contend that a major factor in America's productivity problem is the fact that wages have been rising much faster than increases

in the productivity rate.

Alice Rivlin, director of the Congressional Budget Office, points out, for example, that hourly pay scales in recent years have been climbing about 8 to 9 percent annually, while productivity rates have barely moved. This has resulted in higher unit-labor costs, which have been passed on to customers in inflationary prices.

Some analysts have dug up a 1962 recommendation of the President's Council of Economic Advisers to the effect that wage rates should not rise faster than productivity rates or terrible inflation would follow. At the time, productivity was increasing about 3 percent a year.

Since those years, many labor contracts have automatically assumed a 3 percent increase in productivity as a starting point in wage negotiations. This rate, coupled with built-in increases to keep pace with the Cost of Living Index, has resulted in inflationary wage increases because America has not experienced anything close to a 3 percent productivity increase in more than a decade.

Inflationary pressures would be reduced, many observers believe, if wage increases were tied more closely to improvements in productivity.

Lack of Managerial Attention—At least one critic argues that productivity has slowed in America because managers simply have not paid enough attention to the problem.

Dr. C. Jackson Grayson, chairman of the American Productivity Center in Houston, says bluntly: "Management has given scant attention to productivity in recent years. They've neglected it in favor of concentrating on such things as market share, mergers, acquisitions, and so on. They've tried to play the earnings game while ignoring the supply side of their operations."

Some experts also say the growing influx of women and younger workers in the labor market has been a drag on productivity.

They contend that many of these workers enter jobs with little training or experience and, therefore, are incapable of producing efficiently until they have been on the job awhile.

Some say the fact that there are so many more of these newcomers to the job market than ever before helps retard productivity growth.

If all these are some of the leading causes of reduced productivity, what can we do to reverse the trend?

Experts, of course, do not agree on the answer — or answers — to this question. Many of the possible solutions are loaded with controversial political and social implications, perhaps radical changes in the way we have conducted business and civil life in America over the last two decades.

Some of the more provocative adjustments would focus on such questions as these:

How much of our Gross National Product can continue to be diverted into government and service industries, where productivity is difficult to measure at best or is non-existent at worst?

What are reasonable and realistic profit margins for corporations, and what percentage of those earnings needs to be reinvested for future productivity gains?

Is there an imbalance between personal savings and what one economist has called "conspicuous consumption?" Are we borrowing too much from the future to pay for our present standard of living?

How much should we spend for R & D? Should we be concerned that two-thirds of all research today is conducted by foreign laboratories?

Should wage increases be tied to actual rather than imagined productivity increases in the future, thus eliminating one artificial stimulus to rising prices?

The answers to such explosive questions are not obvious, of course. If they were, the problem of sagging productivity would have been resolved long ago.

There are, however, less controversial approaches to increasing productivity — steps involving both individual and collective action.

For example, employers and employees alike need to recognize the importance of continuing education programs to improve skills and techniques for increased production.

A second step could be accelerated educational-motivational programs by companies to show employees why they have a vital stake in corporate profits and how their jobs depend on remaining competitive in both domestic and world markets. Some workers, whose performance can only be characterized as lackluster, need to be reminded of the words of pioneer labor leader Samuel Gompers: "The worst crime against working people is a company which fails to operate at a profit."

Third, managers need to reward increased productivity through bigger paychecks, promotions and bonuses. For example, workers could agree to a formula for wage hikes and bonuses based on improved productivity.

Fourth, workers need to be less resistant to technological innovation which can stimulate productivity. Admittedly, some changes may lead to temporary dislocation and inconvenience for some employees. But the historical record shows that new technology usually produces *more* jobs in the long run as economic growth occurs.

These less controversial steps alone will not lead America back to the high productivity standards of the 1960s. Perhaps those levels will never be possible again. But they surely would make a dent in the problem while the larger questions are still being debated.

The urgency of beginning somewhere to stimulate productivity anew is almost beyond debate. Perhaps no one has stated the case more strongly than Peter F. Drucker, the widely-read and universally-respected analyst of business problems.

He says simply, "I believe that the greatest immediate need of business management today is to go to work again on productivity. It is an area which we took for granted 15 years ago, but it will be *the* central economic problem for all the developed countries in the next 15 to 20 years."

At stake in the outcome may well be the American economic system as we have known it. For if both the individual worker and the corporation do not find ways to improve productivity, America will continue to lose in international economic competition. If those losses continue, we will soon forfeit any claim to being a major world power — and that prospect is too frightening to contemplate.